



REPORT TO EXECUTIVE COUNCIL
ON BENNER INDUSTRIES LTD.
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SECTION I: AUTHORITY

The audit was performed under Section 14(d) of the Audit Act in conjunction with a Decision of Executive Council
- D595/83 - dated August 19, 1983.

SECTION II: TERMS OF REFERENCE

The Decision of Executive Council did not provide specific terms of reference. Subsequently, in a discussion with the Honourable Pat Binns, Minister Responsible for Industrial Enterprises Incorporated, more specific terms were established as follows:

- An investigation into the affairs of Benner Industries Ltd. from recruitment until closure.
- Have the conditions of the loan been met?
- Examination of possible conflict of interest re Mr. Ivan MacKenzie.

SECTION III: INTRODUCTION

Given the urgency of the situation, I was unable to do a complete investigation which would require more time and resources than I had available. In reconstructing the story of Benner Industries Ltd. I had to rely on sketchy documentation, supplemented substantially by interviews often with conflicting opinions and by recollections from my 1979 audit on Industrial Enterprises Inc. The documentation included many overly optimistic projections lacking in documented assumptions and provided by Benner management which had a continuous record of producing actual results well below their predictions. From this information base I attempted to reconstruct a likely and reasonable history of Benner Industries Ltd.

The observations made are the result of this investigation and are not intended nor should they be interpreted to reflect on the integrity of any individual.

SECTION IV: THE STORY OF BENNER

History:

In 1978 Benner Industries was recruited as a potential occupant of the Industrial Park. Benner senior had operated a successful ski manufacturing operation in Germany for many years. In view of a booming cross country ski market, Benner Germany decided to establish a Canadian manufacturing operation. Benner senior died before the company began production.

Did Benner Industries have a viable potential?

The following factors can be listed on the positive side:

- Benner senior had a longstanding experience in manufacturing and selling skis.
- In 1978 the market for cross country skis was substantial.
- Benner was willing to back the new operation with substantial funds.
- Employees for the Canadian operation were trained in Germany prior to opening the Canadian factory.
- The rim injection process offered many potentials for alternative products.

The following factors can be listed on the negative side:

- The severe competition from established firms and from new entrants with the resulting possibility of market saturation did not appear to have been considered.

- Benner apparently had no experience with the rim injection process only with the laminate process used in its German operation.
- The Canadian facility was too expensive for a corporation not as yet firmly established and may have been designed as much as a showpiece as for utility.

In my opinion in the light of the times, although risks were involved, potentially Benner was a good prospect. The positive points speak for themselves and negative ones could have been overcome by attracting management with Canadian experience and a production manager familiar with the rim injection process. The risk of decreased demand for skis could have been hedged by the potential for alternative products.

The Period Between Fall 1979 and September 1982:

The plant was constructed under a turnkey contract and production was scheduled to begin in the Fall of 1979. Construction problems delayed this until the Spring of 1980, causing excessive start-up costs.

Several new manufacturers had entered the field and a lack of snow for several years after the plant opened for business decreased the demand for skis. All this added up to fierce competition and depressed prices. A recent consultant's study indicates that the Canadian market of 800,000 pairs of cross country skis in 1978/79 had dropped to approximately 300,000 pairs in 1980/81. The US market showed a similar decline, from 632,000 to 300,000 pairs of skis.

The Benners however remained determined to establish a brand name product, apparently unaware of the high cost of establishing a brand name, and not having the funds available to carry it off. Cross country skiing at the time was somewhat of a fad, opening a large market primarily for low price products. As a result Benner Industries was placed in a position whereby it had to sell a high cost quality product in a market where the demand was primarily for low priced ones.

Management blamed high cost of sales, which according to audited financial statements were consistently well above net selling prices, on low production levels. This left no room for recovering selling and administrative overheads and interest, which in themselves already were excessive.

The consistent high losses caused a rapidly deteriorating financial position. A new shareholder infused substantial funds and I.E.I. approved an additional loan of \$500,000 in December 1980.

Management: Absentee management prevailed during this period. Successive sales managers appeared to lack connections and experience in sporting goods sales. It would appear the company did not have an experienced production manager.

Sales: The company lacked sales, due to a collapse of the ski market and the resulting fierce competition, lack of snow and its apparent attempts to establish its own brand name ski. The facilities were set up to produce 70,000 pairs of skis per annum

on a one shift basis. Actual sales volumes were: 1981: 15,600 pairs of skis; 1982: 25,800 pairs. A recent consultant's study indicated that a volume of 55,000 pairs was needed to reach breakeven production volume. The same study indicated that this volume was not likely to be reached for several years.

Production: The high cost of production could be indicative of poor production management, although generally it was blamed on lack of volume and high fixed production costs. The effect of the latter however was highly overrated, because these costs were kept low by rent subsidies received from I.E.I. That the production problems were severe, was borne out by an experienced production manager hired in 1983, who apparently succeeded in sharply reducing unit production costs.

For lack of a cost accounting system and production records, these conclusions are, although in my opinion correct, difficult to prove.

The Period After September 1982:

Losses incurred since 1980 were very high, close to \$3 million by September 1982. In spite of the substantial infusion of funds by Mr. Assam Azzabi the company was on the verge of bankruptcy. Mr. Azzabi solicited the assistance of his brother, Ramadan, who declared himself willing to make an investment of \$1 million via a venture capital company, A-Z Ventures, provided I.E.I. would match his investment by a

loan for a similar amount. The request was placed before the Board of I.E.I. in September 1982 and recommended to Executive Council for approval.

From discussions with the Board it was apparent that its recommendation was based on the following considerations:

- The confidence of the new shareholder in Benner's future was evidenced by his willingness to make a substantial investment amount, something which few of I.E.I.'s other clients have offered when requesting additional loans.
- The Board considered that with good management the Company would have potential for success, and the new shareholder promised to appoint a capable management team.
- It was expected that Tyrol and Hart, two widely known ski companies would soon complete negotiations started in 1981, to have Benner manufacture skis under contract at an attractive price more in line with the quality of Benner's products. The Chairman of the Board of I.E.I. advised me that he had been told by one of the Companies that Benner was a quality manufacturing operation they would entrust with manufacturing their top quality skis.
- Benner was one of the few remaining major manufacturers still operating in the Park and 30 to 40 jobs were at stake.
- I.E.I. would recover half of its loan in payments on arrears and settlement of an outstanding loan guarantee.

In my opinion negotiations should have been conducted on the basis of taking over a bankrupt business in which case I.E.I. and the bank would have had to reduce its debts, which they now have to do in any case. In fact such a presentation was made in August 1983 just before Benner closed its doors. If negotiations would have been conducted on that basis, the company with the infusion of \$2 million new capital might have had some chance of survival, although substantial additional funds would have been needed later on.

Mr. Azzabi did make good on his promise to provide a new management team, but far too late. A production manager, experienced in ski manufacturing, started in January 1983; a general manager assumed his position on March 1, 1983 and a sales manager with actual experience and connections in the sporting goods field, started in May 1983.

The fact that Benner was a showpiece in the Industrial Park, contributed to its undoing. I have been told that the plant was twice as big as it should have been and three times as costly.

Furthermore, in order to maintain its production crew, the company substantially manufactured for inventory, with the resulting high cost of interest on investment.

The new management team appeared to have made a good start in addressing the problems besetting Benner, in an

aggressive manner. The action taken as planned would have given the company a reasonable chance for survival two or even one year earlier.

However, funds ran out. The two million projected as needed in September 1982 were insufficient, because at the time the financial situation of the company was apparently far worse than either the shareholders or I.E.I. suspected. Also, by the time the new sales manager appeared on the scene the favourable time for obtaining orders had, I understand, largely expired.

In the end the shareholders, short of providing substantial additional funds, had little choice but to close the doors, which they did in August 1983.

SECTION V: COST AND CAUSES OF FAILURE

In my opinion the causes of failure can be summarized as follows:

- Absentee management.
- Lack of management with experience - especially Canadian experience - in general management, sales and production - three of the most critical areas in the operation of any company.
- Lack of a well-defined and realistic marketing philosophy.
- Lack of long term financial planning.
- Failure to recognize the severe deterioration of the ski market between the time the Canadian operation was conceived in 1978 and the start of production in early 1980.
- Failure to capitalize on the opportunities to manufacture alternate products to reduce production overhead.
- The high cost of production for inventory.
- Poor co-ordination between sales and production.
- Lack of production standards.
- Lack of a cost accounting system.
- Excessive administrative and sales overhead.

Funds provided in the attempt to establish Benner as a viable industry, the benefits of which are now lost, are summarized below:

Shareholders	\$ 4,000,000
I.E.I. - net of estimated recovery*	3,800,000
Federal Government	1,800,000
Bank - estimated*	400,000
	<u>\$10,000,000</u>

* In our opinion these are conservative estimates.

SECTION VI: DISPOSITION OF LOAN PROCEEDS

How was the additional \$2 million spent?

The loan proceeds were advanced in December 1982 and January 1983 and for the most part disbursed by Benner's March 31, 1983 year end. An audit was conducted by a public accounting firm on the financial statements for the year ended March 31, 1983. To provide a conclusive answer to the question of how the funds were spent would have required substantial work, much of it duplicating the efforts of the public accounting firm. I could not spare the necessary staff nor did I deem it cost justified to engage a private firm for this task. I therefore limited my investigation of this question to reviewing the audited financial statements, discussions with the auditor and scanning the cash disbursements records subsequent to March 31, 1983. It appears that as soon as the funds were received, they were spent on reducing bank loans, repaying bridge financing by A and A Holdings, and paying arrears on other I.E.I. loans.

The production manager advised me that approximately \$30,000 was spent subsequent to the loan approval, on purchase of used machinery for improving operating efficiency and product quality.

Auditor's Opinion

In my opinion the loan proceeds were used as part of

management's effort to keep the company solvent. I have not found any evidence or indication that funds were withdrawn from the company for other than business purposes.

SECTION VII: HAVE THE CONDITIONS OF THE LOAN BEEN MET

General: The loan referred to is a \$1 million loan to A-2 Ventures Inc. under the Venture Capital Program approved by Decision of Executive Council - D800/82 - dated November 4, 1982.

The purpose of the loan was to make \$2 million available for refinancing of Benner Industries Ltd. by requiring the shareholder to put in a matching amount. The loan was extended for 10 years with interest forgiven during the first five years as follows:

Year One	-	100%
Year Two	-	100%
Year Three	-	75%
Year Four	-	50%
Year Five	-	25%

The principal was to be amortized over a five year period commencing five years from the date of the first advance in equal quarterly payments of principal plus accrued interest.

Although the shareholders and I.E.I. were supposed to contribute \$1 million each, in fact, the shareholders invested \$1.25 million, and I.E.I., effectively, half a million dollars. Although its loan was for \$1 million, half of it was used to cover arrears on its other loans and payment of a bank loan guaranteed by I.E.I.

Approval of the loan was subject to the following conditions:

A. Conditions per Decision of Executive Council to be met prior to disbursement

- (a) I.E.I. accounts will be brought to current status.
- (b) Existing loan guarantees of \$180,000 be cancelled.
- (c) At least \$250,000 of present bank guarantees of Assam Azzabi be converted to equity and utilized to pay down short term bank debt. In addition Benner Industries Ltd. will utilize its best efforts to further reduce interest charges through acquisition of \$250,000 financing at an approximate interest rate of 10% and through application for a Small Business Development Bond in the amount of \$500,000.
- (d) At least \$1.75 million (\$1 million from A-Z Ventures plus \$750,000 from I.E.I.) must be injected immediately by the Venture Capital Corporation and not in stages over the period to November, 1983. The remaining \$250,000 from I.E.I. will be advanced when the \$250,000 guarantee of Assam Azzabi is converted to equity and applied against short term bank debts.
- (e) A-Z Ventures Ltd. will negotiate a management contract with Benner Industries Ltd. in a form suitable to I.E.I.
- (f) Of the \$2 million invested by A-Z Ventures in Benner Industries Ltd. \$1 million will be in common shares and the remainder will be under a 10 year term loan. Interest and principal repayment by Benner Industries Ltd. to A-Z Ventures Inc. will be on same terms as A-Z Ventures is charged by I.E.I.

B. Other conditions laid down by I.E.I. in its loan agreement

The loan agreement contained additional conditions of a more technical nature, covering the submission of financial reports, dividend payments, shareholders' loans, etc.

Auditor's Report

I have reviewed legal documents, audited financial statements, correspondence and other evidence to determine if the loan conditions per the Executive Council decision were fulfilled prior to disbursement of the funds.

I have concluded that all the conditions prior to disbursement were met with the exception of condition (c). The bank guarantee of \$250,000 was paid; however, it was converted to a shareholder's loan instead of equity as required in the loan conditions. Equity is often understood as an equivalent of share capital. As such the condition was not met, but the loan agreement stipulated that neither principal nor interest could be paid without prior I.E.I. approval.

Most of the "other conditions" lost their relevancy because Benner Industries Ltd. discontinued its operation in August 1983. The loan agreement prescribed rather specific procedures for the disbursement of funds. Formally they were not followed but in essence the same effect was achieved by alternate means.

SECTION VIII: CONFLICT OF INTEREST

Mr. Ivan MacKenzie was Deputy Minister of the Department of Industry and an ex officio member of the Board of Directors of Industrial Enterprises Inc., when it recommended approval of the loan to Executive Council.

Mr. MacKenzie stated to me that he was first approached sometime in late December, after the loan was approved by Council, by the shareholders of A-Z Ventures Inc. with an offer to become the manager of Benner Industries Ltd. As part of the negotiations he requested a one time inducement, settled at \$65,000, in addition to his annual salary, to relinquish his position as Deputy Minister of Industry. The shareholders agreed and part of the amount was paid in trust before he assumed his new position. The balance was to be paid at a later date when cash flow would allow payment. The final payment was made in early May. Mr. MacKenzie assumed his position with the company on March 1, 1983.

Because of a possible conflict of interest on the part of Mr. MacKenzie, the Leader of the Opposition called for a Commission of Inquiry to clarify whether or not Mr. MacKenzie had unduly influenced any party involved in discussions leading to approval of the loan with the intent to obtain an appointment as General Manager of Benner Industries Ltd.

No auditor, or Commission of Inquiry, can ascertain

with certainty what anyone's motives are at any given time. My only recourse therefore was to question Mr. MacKenzie and others and to remain alert throughout my investigation for any signs or evidence of wrongdoing on his part.

Auditor's Opinion

In the course of my investigation I did not find any evidence that Mr. MacKenzie used his position with Government to unduly influence securing the loan to, or promotion of, his employment with Benner Industries Ltd.

POOR

QUALITY

ORIGINAL

